ETHICS IN STATE TAXATION
(MINDING YOUR P'S AND Q'S)[1]

(John Warren)

A. Ex Parte Communications in Income and Franchise Tax Appeals.

1. Rule 5-300 of the California Rules of Professional Conduct states:

> (B) A member shall not directly or indirectly communicate with or argue to a judge or judicial officer upon the merits of a contested matter pending before such judge or judicial officer except:
>
> (1) In open court; or
>
> (2) With the consent of all other counsel in such matter; or
>
> (3) In the presence of all other counsel in such matter;
>
> (4) In writing with a copy thereof furnished to such other counsel; or
>
> (5) In ex parte matters.
>
> (C) As used in this rule, 'judge' and 'judicial officer' shall include law clerks, research attorneys, or other court personnel who participate in the decision-making process.

2. Formal Opinion No. 1984-82 of the State Bar Committee on Professional Responsibility and Conduct considered whether rule 7-108(B), the predecessor rule 5-300, should apply to administrative agency proceedings, inasmuch as agency members are not literally judges or judicial officers. "Nonetheless, in light of the principles underlying rule 7-108(B) and the considerations of fairness and impartiality outlined above, the Committee believes that, when the agency has elected to have the case heard before the agency itself, the agency is performing functions equivalent to a judge or judicial officer, and must be considered as a 'judicial officer' within the meaning of rule 7-108(B) during the limited period of time when the case is pending decision."

---

[1] The views expressed by each individual panel member are the views of that individual and do not necessarily reflect the views of the Franchise Tax Board.

3. Has the rule been followed in appeals to the State Board of Equalization (SBE) from actions of the Franchise Tax Board (FTB)?

a. In the late 1980s, the FTB issued instructions to its staff not to engage in ex-parte communications with the SBE staff regarding pending appeals. Those instructions are still in effect today.

b. Taxpayers are now commonly discussing their appeals with SBE members prior to the hearing.

4. Should rule 5-300 be observed in appeals to the SBE?

a. No. The rule need not be observed for the following reasons:

(1) The SBE is not a court, so the rule is literally inapplicable.

(2) Government Code section 15609.5 (1992) excludes the SBE from the adjudication provisions of the Administrative Procedure Act, so Formal Opinion No. 1984-82 is irrelevant.

(3) Board members are popularly elected and should be freely accessible to the constituents.

b. Yes. The rule should be observed for the following reasons:

(1) Adversarial matters should not be prejudged on the basis of one party's view of the case. That is unfair to the other party.

(2) The reasons for the tax bar's objections to the old practice are equally applicable to the new practice and perhaps more so because, unlike the taxpayer, the FTB cannot go on to court from an SBE ruling against it.

(3) Decisions overly influenced by one party may turn out to be unsound and unworthy of reliance.

(Richard Solomon)
B. Frivolous Appeals To The State Board Of Equalization

1. The standard:

a. California Revenue and Taxation Code section 19714 allows the Board of Equalization to impose up to $5000 penalty when it concludes that the proceedings were instituted or maintained primarily for delay or the position asserted is frivolous or groundless.

b. The Board of Equalization has recently noticed "an increase in … appeals … that are based on contentions that are totally without merit and that have been uniformly rejected for many years by this Board as well as by state and federal courts." *In the Matter of the Appeal of Myers*, 2001-SBE-001, ($1000 penalty assessed pursuant to Rev. & Tax. Code §19714); see also, *Pierotti v. Torian*, 81 Cal.App.4th 17, 96 Cal.Rptr.2d 553 (2000) (client and lawyers ordered to pay $16,000 each in fines and sanctions pursuant to Cal. Code Civ.Proc. § 907 for prosecuting a frivolous appeal).

c. California Rules of Professional Conduct, rule 3-200:

> A member shall not seek, accept, or continue employment if the member knows or should know that the objective of such employment is:
>
> (A) To bring an action, … assert a position in litigation, or take an appeal, without probable cause and for the purpose of harassing or maliciously injuring any person; or
>
> (B) To present a claim or defense in litigation that is not warranted under existing law, unless it can be supported by a good faith argument for an extension, modification, or reversal of such existing law.

2. Discussion Questions:

a. Sanctioning mis-use of the appellate process is in tension with allowing room for (or not unduly squelching) "long shot" creative arguments. Is the standard of "frivolousness" inescapably subjective ("I know a frivolous argument when I see it") or might/should it have an objective basis?

b. In *Myers*, above, the taxpayer defined "gross income" so as to exclude his own income based on the arguments (i) that because he is a

"citizen" of California he is not a "resident" of California and that California's income tax laws apply only to "residents;" and (ii) he received "remuneration" rather than "compensation" for his dentistry services. This is an easy case.

(Kathleen Andleman)
C. Duty to Report Federal Adjustments to the Franchise Tax Board

1. Rule 5-220, California Professional Rules of Conduct: "A member shall not suppress any evidence that the member or the member's client has a legal obligation to reveal or to produce."

2. Requirements to Report Federal Adjustments under the California Revenue and Taxation Code.

a. The taxpayer has six months from the date of the final federal determination to report changes.

Revenue and Taxation Code section 18622:

> (a) If any item required to be shown on a federal tax return, including any gross income, deduction, penalty, credit, or tax for any year of any taxpayer is changed or corrected by the Commissioner of Internal Revenue or other officer of the United States or other competent authority, or where a renegotiation of a contract or subcontract with the United States results in a change in gross income or deductions, that taxpayer shall report each change or correction, or the results of the renegotiation, within six months after the date of each final federal determination of the change or correction or renegotiation, or as required by the Franchise Tax Board, and shall concede the accuracy of the determination or state wherein it is erroneous. For any individual subject to tax under Part 10 (commencing with Section 17001), changes or corrections need not be reported unless they increase the amount of tax payable under Part 10 (commencing with Section 17001) for any year.
>
> (b) Any taxpayer filing an amended return with the Commissioner of Internal Revenue shall also file within six months thereafter an amended return with the Franchise Tax Board which shall contain any information as it shall require. For any individual subject to tax under Part 10 (commencing with Section 17001), an amended return need not be filed unless the change therein would increase the amount of tax

payable under Part 10 (commencing with Section 17001) for any year.

(c) Notification of a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority, or renegotiation of a contract or subcontract with the United States that results in a change in any item or the filing of an amended return must be sufficiently detailed to allow computation of the resulting California tax change and shall be reported in the form and manner as prescribed by the Franchise Tax Board.

(d) For purposes of this part, the date of each final federal determination shall be the date on which each adjustment or resolution resulting from an Internal Revenue Service examination is assessed pursuant to Section 6203 of the Internal Revenue Code.

b. If the taxpayer reports the changes, the Franchise Tax Board has two years in which to issue a notice of proposed assessment.

Revenue and Taxation Code §19059:

(a) If a taxpayer is required by subdivision (a) of Section 18622 to report a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority and does report the change or correction within six months after the final federal determination, or the Internal Revenue Service reports that change or correction within six months after the final federal determination, a notice of proposed deficiency assessment resulting from those adjustments may be mailed to the taxpayer within two years from the date when the notice is filed with the Franchise Tax Board by the taxpayer or the Internal Revenue Service, or within the periods provided in Section 19057,19058, or 19065, whichever period expires later.

(b) If a taxpayer is required by subdivision (b) of Section 18622 to file an amended return and does file the return within six months of filing an amended return with the Commissioner of Internal Revenue, a notice of proposed deficiency assessment in excess of the self-assessed tax on the amended return, and resulting from the adjustments may be mailed to the taxpayer within two years from the date

when the amended return is filed with the Franchise Tax Board by the taxpayer, or within the periods provided in Section 19057,19058, or 19065, whichever period expires later.

c. Failure to report extends the time in which the Franchise Tax Board an issue notices of proposed deficiency assessments to four years.

Revenue and Taxation Code section 19060:

(a) If a taxpayer fails to report a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority or fails to file an amended return as required by Section 18622, a notice of proposed deficiency assessment resulting from the adjustment may be mailed to the taxpayer at any time.

(b) If, after the six-month period required in Section 18622, a taxpayer or the Internal Revenue Service reports a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority or files an amended return as required by Section 18622, a notice of proposed deficiency assessment resulting from the adjustment may be mailed to the taxpayer within four years from the date the taxpayer or the Internal Revenue Service notifies the Franchise Tax Board of that change or correction or files that return.

(John Warren)
D. Advising Clients on Residency Issues

1. Planning advice.

a. In giving advice on how to avoid becoming a resident (inbound case) or how to become a nonresident (outbound case), the tax advisor must be careful not to lead the client into manufacturing the facts that will be helpful to his case. Subterfuge must be warned against.

b. This is especially true in an outbound case, for in a few such cases the FTB has brought criminal tax fraud charges against the taxpayer, raising the possibility that the tax advisor could be charged with collaboration.

2. Audit advice.

a. The FTB residence unit has a reputation for tenacity. Its investigations can be tediously long. Then if the audit determination is protested, further fact-finding may be conducted by the hearing officer. Is there a point at which requests for information can be ethically resisted?

b. The general rule in tax audits is that relevance and materiality are within the sole discretion of the auditor. (Treasury Circular 230 allows resistance to a request for records or information only if the practitioner has a good faith belief that "such record of information is privileged or that the request for, or effort to obtain, such record of information is of doubtful legality.") But residence audits may be different.

c. California Revenue and Taxation Code section 19381 is a unique provision that allows declaratory relief in residence cases. Enacted in 1955, its purpose was to allow individuals to shift their case from FTB inquisition to court-supervised discovery procedures. It does require the individual to first go through the protest and appeal process which in the '50s required perhaps six months, but today can require two or three years, so the provision is not now as useful to taxpayers as the Legislature intended.

d. Nevertheless, the author believes that the existence of California Revenue and Taxation Code section 19381 justifies the taxpayer to respond to wide-ranging residence inquiries the same way he would respond in a court deposition, e.g., "Taxpayer objects to the question on the ground that it seeks information that is not relevant to the proceeding and is not reasonably calculated to lead to the discovery of admissible evidence."

(Richard Solomon)
E. Ethical Dilemmas Arising From Settlement Negotiations

1. The standards:

a. California Evidence Code section1152: offers and statements to settle a dispute are inadmissible to prove liability; California Evidence Code section 1154: offers or promises to /accept consideration to satisfy a claim are inadmissible to prove the invalidity of the claim or any part of it.

b. The mediation privilege codified at California Evidence Code sections 1115-1128 is broader: no statements made during mediation sessions are admissible, regardless of the purpose offered.

c. The distinction is important. Evidence offered for purposes *other*

than liability may be admissible under section 1152 of the California Evidence Code. (See, e.g., *In re Dept. of Fair Employment & Housing v. Jevremov*, 1997 CA FEHC Lexis 1, 16 (FEHC 1997)); (Section 1152, subdivision (a) does not prevent admission of a statement to the department by someone charged with discriminatory treatment offered to prove that he corrected the unlawful practice with which he had been charged); *In the Matter of the Appeal of Farmer Bros. Co.,* 1999 CA OSHA App. Bd. Lexis 164, slip op. at p. 14 (CA OSHA Appeals Bd., 1999).

d. But one court has ruled that section 1119 is not absolute and "must yield if it conflicts with [a] minor's constitutional right to effective impeachment of an adverse witness in [the] juvenile delinquency proceeding." *Rinaker v. Superior Court of San Joaquin County*, 62 Cal.App.4th 155, 165, 74 Cal.Rptr.2d 464 (1998) (minors and victim participated in voluntary mediation, agreeing to confidentiality; court must determine, in camera, whether victim's statements in mediation were sufficient impeachment and therefor admissible to vindicate the minor's right of confrontation).

e. Lawyers bargaining with third parties on behalf of clients at arm's length owe a duty not to defraud the other party. *Cicone v. URS Corp.,* 183 Cal.App.3d 194, 202, 227 Cal.Rptr. 887 (1986) (actionable misrepresentations limited to affirmations of fact); ABA Model Rules of Professional Conduct, rule 4.1 ("In the course of representing a client a lawyer shall not knowingly: (a) make a false statement of material fact of law to a third person; or (b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by rule 1.6 [prohibiting disclosure of client secrets]."); cf. California Commercial Code section 2313 (distinguishing between factual affirmations creating express warranties versus affirmations "merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods").

f. A taxpayer's lawyer's failure to point out the Service's unilateral mistake in failing to consider a Code provision in calculating the settlement amount has been considered misleading but not the equivalent of a misrepresentation justifying vacating a stipulated settlement. *Stamm Int'l Corp. v. Commissioner*, 90 T.C. 315 (1988), cited in Issues Statement 1999-1 (ABA Section of Taxation, Standards of Tax Practice, 2000). Assuming the taxing authority is not a "tribunal" (as determined in ABA Formal Opinion 314 (1965)), the higher duty of candor to a tribunal in ABA Rules of Professional Conduct, rule 5-200(B), would not apply.

g. In California, the duty of confidentiality is virtually absolute. (Cal. Bus. & Prof. Code § 6068, subd. (e).) Thus, if counsel learns from the

client that the other party to the negotiation has made a significant mistake, counsel may not be able to disclose that mistake without the client's consent.

2. Discussion Problems:

a. The FTB uses a standardized agreement to submit disputes to settlement negotiation. Though the process is not mediated, the agreement incorporates the mediation privilege. If the underlying dispute is not resolved, and if criminal tax charges are filed, could the taxpayer/defendant testify to exculpatory statements made by an FTB representative while negotiating?

(Kathleen Andleman)

F. The Revolving Door: Ethical Considerations When Leaving State Government for Private Practice

1. California Professional Rules of Conduct, rule 3-310(E):

A member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment.

2. State officials are prohibited from directly and indirectly participating in proceedings in which they have a conflict of interest.

a. California Business and Professions Code section 6068:

It is the duty of an attorney to do all of the following: (e) To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client.

b. California Government Code section 87401:

No former state administrative official, after the termination of his or her employment or term of office, shall for compensation act as agent or attorney for, or otherwise represent, any other person (other than the State of California) before any court or state administrative agency or any officer or employee thereof by making any formal or informal appearance, or by making any oral or written communication with the intent to influence, in connection with any judicial, quasi-judicial or other proceeding if both of the following apply:

(a) The State of California is a party or has a direct and substantial interest.

(b) The proceeding is one in which the former state administrative official participated.

c. California Government Code section 87402:

No former state administrative official, after the termination of his or her employment or term of office shall for compensation aid, advise, counsel, consult or assist in representing any other person (except the State of California) in any proceeding in which the official would be prohibited from appearing under Section 87401.

3. Matters Before the Fair Political Practices Commission

a. In the Matter of Douglas Anderson

b. In the Matter of Opinion requested by Steven S. Lucas (Glenn Bystrom)

c. Advice Letter: Anthony Costa

4. Former employees are barred from making an appearance before the agency for one year.

California Government Code section 87406, subdivision (d)(1):

No designated employee of a state administrative agency, any officer, employee, or consultant of a state administrative agency who holds a position which entails the making, or participation in the making, of decisions which may foreseeably have a material effect on any financial interest, and no member of a state administrative agency, for a period of one year after leaving office or employment, shall, for compensation, act as agent or attorney for, or otherwise represent, any other person, by making any formal or informal appearance, or by making any oral or written communication, before any state administrative agency, or officer or employee thereof, for which he or she worked or represented during the 12 months before leaving office or employment, if the appearance or communication is made for the purpose of influencing administrative or legislative action, or influencing any action or proceeding involving the issuance, amendment, awarding, or revocation of a permit, license, grant, or contract, or the sale or purchase of goods or property. For purposes of this paragraph, an

appearance before a state administrative agency does not include an appearance in a court of law, before an administrative law judge, or before the Workers' Compensation Appeals Board. The prohibition of this paragraph shall only apply to designated employees employed by a state administrative agency on or after January 7, 1991.

5. Statutory Definition, California Government Code section 82002:

> "Administrative action" means the proposal, drafting, development, consideration, amendment, enactment or defeat by any state agency of any rule, regulation or other action in any rate-making proceeding or any quasi-legislative proceeding, …

6. Statutory Definitions: California Government Code section 87400:

> Unless the contrary is stated or clearly appears from the context, the definitions set forth in this section shall govern the interpretation of this article.
>
> (a) "State administrative agency" means every state office, department, division, bureau, board and commission, but does not include the Legislature, the courts or any agency in the judicial branch of government.
>
> (b) "State administrative official" means every member, officer, employee or consultant of a state administrative agency who as part of his or her official responsibilities engages in any judicial, quasi-judicial or other proceeding in other than a purely clerical, secretarial or ministerial capacity.
>
> (c) "Judicial, quasi-judicial or other proceeding" means any proceeding, application, request for a ruling or other determination, contract, claim, controversy, investigation, charge, accusation, arrest or other particular matter involving a specific party or parties in any court or state administrative agency, including but not limited to any proceeding governed by Chapter 5 (commencing with Section 11500) of Division 3 of Title 2 of the Government Code.
>
> (d) "Participated" means to have taken part personally and substantially through decision, approval, disapproval, formal written recommendation, rendering advice on a substantial basis, investigation or use of confidential information as an officer or employee, but excluding approval, disapproval or

rendering of legal advisory opinions to departmental or agency staff which do not involve a specific party or parties.

(John Warren)
G. Taking Different Positions on Behalf of Multistate Corporations

1. Taking different positions on returns filed in two or more states is ethically permissible if the differences in reporting can be shown to be justified by differences in income allocation statutes and interpretations among the states.

2. Premeditated creation of nowhere income is unethical. 100% of each apportionment factor should be assigned to some jurisdiction. Or to put it another way, in each factor the sum of the numerator should equal the denominator.

3. Each state's return should meet the internal consistency test, i.e., if the income allocation rules of that state were assumed to apply in each other state where a return is filed, full apportionment would result.

4. In non-combination states, it is unethical to take inconsistent positions on the way the same transaction is reported by affiliated corporations, e.g., reporting a particular payment as deductible interest on a subsidiary's return and as a dividend subject to a dividends received deduction on the parent's return.

5. Providing copies of other state returns.

a. Resisting a request for other state returns might be based on privilege or on a return confidentiality provision in the other state's statute; but the department's subpoena may nevertheless be upheld. (See *Dorgan v. Cargill, Inc.,* No. 25619 (D. Burleigh County, North Dakota).)

b. Resistance may be futile because most states now have statutes authorizing reciprocal exchanges of information with tax agencies of other states. Resistance will also be futile in audits conducted by MTC auditors who will have access to returns filed in all of their client states.

6. How have the courts reacted to inconsistent positions on unity?

a. In *Superior Oil Co. v. Franchise Tax Board*, 368 P.2d 33 (1963), the taxpayer filed in a total of 7 states, using separate accounting in 6 of the 7 states in which it had losses but using formula apportionment in California where it had large profits. The California Supreme Court, after reciting these facts, brushed them off saying, "Of course we are not concerned in this proceeding with the propriety of the methods used to determine taxable income in the other states."

b. In *Russell Stover Candies, Inc. v. Dept. of Revenue of*

Montana, 665 P.2d 198 (1983), the taxpayer reported on a unitary basis in 5 states where its box divisions operated but claimed separate accounting in Montana where its ranch divisions produced losses. The Montana Supreme Court said, "Further, we believe that Ward admitted that the ranches were part of a unitary business by utilizing the unitary business approach when filing corporate income tax forms in other states where it operated. It considered the ranches part of its unitary business to set off income earned in those states with losses incurred in Montana. However, to minimize tax assessment in Montana, Ward asserted that it was a separate entity."

(Richard Solomon)
H. Conflicts Of Interest

1. Will discuss the "hidden agenda" conflict and two types of positional or issue conflicts.

2. "Hidden agenda" conflicts involve a tax lawyer participating in law reform activities which, if successful, may materially benefit a client of the lawyer. Model Rule 6.4 requires disclosure of that fact within the law reform organization (such as a bar section of taxation), although not of the client's identity. (Accord, Section of Taxation Statement of Policy on Conflicts of Interest (ABA, January 18, 1996).)

3. Positional or issue conflicts involve advocacy on behalf of one client which, which if the position advanced is accepted by the relevant tribunal or other official body, may or will materially harm the interests of another client concurrently represented by the lawyer, typically through the establishment of precedent. The Committee on Professional Responsibility and Conduct (COPRAC) has ruled that asserting antagonistic legal positions in separate matters before the same judge is not prohibited, *per se*, by the California rules, but recommends that lawyers disclose such an issue conflict to the affected clients thereby giving the one facing harm the option of retaining other counsel. (Formal Opinion 1989-108.) But the failure to so disclose would not violate the lawyer's duty of loyalty.